FX Daily: Low volatility sees carry trade in focus

FX markets seem rather non-plussed about the threat of a US debt default. Instead, traded levels of volatility are sinking back to pre-Ukraine invasion levels. Investors are expecting a quiet summer. Lower volatility is favouring the carry trade, where currencies in Latin America and Central and Eastern Europe offer the highest risk-adjusted yields

US President Joe Biden met with Speaker Kevin McCarthy at the White House yesterday

USD: Dollar does ok in a carry trade world

Talks to prevent a US Treasury debt default trundle on. Yesterday's discussions between President Joe Biden and House Speaker Kevin McCarthy to raise the debt ceiling were described as 'productive.' Apart from the slightest of kinks in the one-month part of the USD/JPY volatility term structure, it is hard to discern much risk priced around a possible 'X' date (US Treasury runs out of money) in June.

Instead the stand-out is the lower levels of traded FX volatility around the world – both in the developed and emerging FX space. Volatility has fallen back to pre-Ukraine invasion levels in early 2022 as investors fear a prolonged period of unchanged rates, e.g. will the Fed hike, cut, or leave rates unchanged all year? Lower levels of volatility go hand-in-hand with a slightly more constructive risk environment, where the MSCI World equity index is edging up to the highs of the year. Here it seems investors are preferring to put some money to work absent of clear signs of the sky falling in on the back of tighter credit conditions.

Putting money to work in the FX space means a look at the carry trade – or expecting spot FX to outperform steep forward curves. For example, selling USD/MXN three months forward would return 2%, should spot USD/MXN stick around current levels. And looking at volatility-adjusted returns around the world, the currencies of Latin America (especially the Mexican peso) and Central and Eastern Europe (especially the Hungarian forint) offer the best risk-adjusted return. These have been the outperformers this year and could continue to do well unless US debt ceiling negotiations take a turn for the worse.

Offering overnight rates in excess of 5.00%, the dollar scores quite well on carry trade metrics. And the current environment probably explains why the Japanese yen is performing poorly despite all the perceived risk. Expect the dollar to stay slightly bid in this rangy FX environment until there are much clearer signs of US disinflation and a slowing activity – which we have argued is more a story for the third quarter.

For today, look out for US PMI releases, new home sales data and perhaps some remarks from Fed Chair Jerome Powell. DXY to trade well within a 102.80-103.60 range.

Chris Turner

EUR: Positioning still seems quite long

Despite the correction in EUR/USD from nearly 1.11 to 1.08, net speculative long euro positioning still seems quite stretched, and presents an outside risk in EUR/USD to the 1.05 area should conditions drive it there. Such conditions could include serious speculation over another couple of Fed rate hikes (only another 10bp of hikes is currently priced) or severe dislocation in US money markets if the US Treasury gets very close to an unthinkable default on its debt. Neither of those is our baseline view and instead EUR/USD probably hangs around this 1.08 area for a while. We think the third quarter will be the period when clear signs of US disinflation and weaker activity data drive a much more obvious dollar bear trend.

In Europe today, look out for some eurozone May PMI numbers and also the March current account data. Having seen a monthly deficit as wide as €36bn last summer on the back of the energy spike, the eurozone current account is now returning towards more familiar monthly surpluses in the €25-30bn area. This serves as a reminder that EUR/USD is still probably undervalued on a medium-term basis.

Chris Turner

GBP: Services PMI in focus

In the past, the release of services PMI data has been a driver of sterling given the large representation of the services sector in the UK economy. Another positive reading is expected today in the 55 area. Such an outcome would unlikely dent the market's current pricing of an 84% probability that the Bank of England hikes by 25bp on 22 June. Far more important to that debate will be the UK April CPI data released tomorrow.

0.8660-0.8735 is the clear EUR/GBP range and it will probably be tomorrow's CPI figures which pose the best chance of a range break-out.

Chris Turner

NZD: RBNZ to deliver hawkish 25bp hike

In New Zealand, the Reserve Bank of New Zealand (RBNZ) is expected to raise rates by 25bp to 5.50% overnight. This is also our call (more details in our meeting preview) and what markets are fully pricing in, so all eyes will be on the new set of economic and rate forecasts. The RBNZ had originally signalled rates would have peaked at 5.50%, and there hasn't been much in the economic data to suggest an urgency to revise the peak rate higher: the jobs market has remained tight, but inflation slowed more than expected in the first quarter.

What truly changed the economic backdrop was the government's budget announcement last week, with a fiscal boost that exceeded expectations and a sharp revision in growth forecasts, which no longer include a recession this year. When adding consistently higher-than-expected inbound migration figures (which the RBNZ itself deemed as an inflationary event), it is likely that the Reserve Bank will acknowledge fresh upside risks for prices tomorrow, and will add more tightening to the rate projections. Markets are pricing in a 5.80% peak, but we think the RBNZ may push the projected peak up to 6.00%.

NZD/USD remains largely driven by the global and USD story, but AUD/NZD has seen increasing pressure on the Reserve Bank of Australia (RBA)-RBNZ policy divergence. A hawkish 25bp hike by the RBNZ tomorrow could give NZD/USD some support even if USD stays bid while pressuring AUD/NZD further: the 1.0485 December lows may soon be tested.

Francesco Pesole

Authors

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com